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Union Pacific Corp. (UNP)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings. Welcome to the Union Pacific Second Quarter Earnings Call. At this time, all participants will be in listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded, and the slides for today's presentation are available on Union Pacific's website.

It is now my pleasure to introduce your host, Mr. Lance Fritz, Chairman, President and CEO for Union Pacific. Thank you. Mr. Fritz, you may now begin.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

And thank you, Rob, and good morning, and welcome to Union Pacific's second quarter earnings conference call. With me today in Omaha are Kenny Rucker, Executive Vice President of Marketing and Sales; Eric Gehring, Executive Vice President of Operations; and Jennifer Hamann, our Chief Financial Officer.

As we expected, and shared back in April during our first quarter earnings call, the second quarter was a tough quarter. Our initiatives to restore fluidity limited carloadings and increased operating costs. Those actions are working. We made solid progress improving the network with increased car velocity, reduced car dwell, and reduced excess inventory. But before we get into that discussion, I want to recognize the Union Pacific team that is making it happen. Our people truly are special, and they're the foundation of our long-term success.

Now, turning to our second quarter results. This morning, Union Pacific is reporting 2022 second quarter net income of \$1.8 billion or \$2.93 per share. This compares to second quarter 2021 results of \$1.8 billion or \$2.72 per share. Our second quarter operating ratio of 60.2% deteriorated 510 basis points versus 2021. Network recovery efforts and record high fuel prices were headwinds. However, fuel surcharge revenue, strong core pricing gains, and a positive business mix offset these pressures to produce operating income growth.

As we discussed during the quarter, we understood that the actions we took to improve fluidity would impact our financial performance. Those actions were necessary to increase the speed of our recovery and be in a better position to handle customer demand. The improvements we've made since mid-April gives me confidence that we'll grow volumes as we continue to improve service in the third and fourth quarters. There's more to be done, but we're moving in the right direction.

Let me turn it over to Kenny for an update on the business environment.

Kenny Rucker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

Thank you, Lance, and good morning. Second quarter volume was down 1% compared to a year ago. Growth in our Industrial was more than offset by a decline in our Premium and Bulk business segments. To improve network fluidity, we made reductions to our active freight car inventory, and those efforts had a negative impact on all three of our business groups. In addition, our intermodal volume was down due to continued global supply chain disruptions. Freight revenue was up 14%, driven by higher fuel surcharges, strong pricing gains, and a positive mix.

Let's take a closer look at each of these business groups. Starting with Bulk, revenue for the quarter was up 10% compared to last year, driven by a 12% increase in average revenue per car reflecting higher fuel surcharges and solid core pricing gains. Volume was down 1% year-over-year. Coal and renewable carloads grew 2% year-over-year, driven by continued favorable natural gas prices and two new contract wins that started on January 1. Grain and grain products volume was down 4% due to fewer grain shipments from longer shuttle cycle times, partially offset by increased shipments of biofuels. Fertilizer carloads were down 2% year-over-year due to reduced shipments of sulfur and domestic consumed potash. And lastly, food and refrigerated volume remained flat in the quarter as inventory reduction efforts limited car supply.

Moving on to Industrial, Industrial revenue was up 12% for the quarter, driven by a 6% increase in volume and a 7% improvement in average revenue per car due to higher fuel surcharges and core pricing gains. Overall volume was up, although we certainly left demand on the table as we took actions to reduce car inventory to improve the network. Energy and specialized shipments were up 2% compared to 2021, driven by improvements across various markets, partially offset by fewer petroleum shipments. Volume for forest products was down 2% year-over-year, primarily driven by our service challenges, although overall demand for forest products remained steady in the quarter.

Industrial chemicals and plastic shipments were up 3% year-over-year due to new business wins and demand within the plastics market. Metals and minerals volumes continued to deliver year-over-year growth. Volume was up 13% compared to last year, primarily driven by growth in construction materials and increase in frac sand shipments and metals business development.

Turning to Premium, revenue for the quarter was up 19% on a 5% decrease in volume versus last year. Average revenue per car increased by 26% due to higher fuel surcharge revenue, core pricing gains, and a positive mix of traffic. Automotive volume was up 11%, driven by auto parts which increased 12% and finished vehicles increasing 10%, both driven by strong demand against a softer comparison. Intermodal volume was down 8% primarily driven by service challenges and fewer international shipments from continued global supply chain disruptions. Domestic volume was up 1% in the quarter, aided by tight truck capacity and private asset growth, offsetting weaker parcel shipments.

Now, moving to our outlook for the back half of 2022. At a macro level, we will be closely watching our markets to see how rising inflation and interest rates will impact our overall volumes. But based on our conversations with customers, I'm excited about the opportunities that are in front of us.

Let's start out with our Bulk commodities. We expect biofuel shipments to grow due to solid market demand and business development wins. For coal, we anticipate continued favorable natural gas prices throughout the year. We know there is more demand available than what we've captured to date, so our opportunity is to better match our resources to that demand. And our outlook for grain is also dependent on our service recovery where we expect cycle times to improve. But we have a tough comp in the fourth quarter as exports were strong last year.

Moving on to Industrial, our outlook has not changed. We expect our markets to be stronger than the current industrial production forecast. Customer expansions and business development wins will drive growth in our Industrial chemicals and plastics commodity groups. We do not expect to see petroleum shipments return to 2021 levels.

And lastly, for Premium, we are closely monitoring domestic intermodal demand as supply truck rates have softened. We expect to see improvement to international intermodal with the recovery from the supply chain challenges and pandemic shutdowns in China. However, we will continue to monitor [ph] end receivers (00:07:55)

to make sure we maintain fluidity throughout the entire supply chain, from the ports to the warehouses. In spite of elevated fuel prices and interest rate increases, we expect automotive growth in the second half of the year to be driven by improving supply of semiconductor chips and pent-up demand.

Overall, I'm optimistic about the demand environment we see in the marketplace as we head into the third quarter, and you'll hear from Eric that we're seeing positive momentum in our service products. I want to thank our operating team and our customers for working together to recover our service levels. As we continue to improve the network, I'm confident that we can capture more growth in the back half of the year and into 2023.

With that, I'll turn it over to Eric to review our operational performance.

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

Thanks, Kenny, and good morning. Beginning on slide 9, as we discussed in April, we began the quarter with our service product in need of significant improvement. To recover the network and better serve our customers, we implemented decisive measures to reduce inventory levels and restore fluidity. The chart on slide 9 shows the current state of operations. We hit a trough in April and have since made steady progress. While the improvement has not been a straight line because of continued crew challenges and isolated incidents, the team has stayed the course to build momentum and generate positive results.

We experienced reduced crew availability from the Father's Day and Fourth of July holidays as we expected and planned for. We have, however, recovered from those holiday impacts and returned to our prior improvement trajectory. We continue to see the benefits of our hiring initiatives and feel confident in our ability to hire and train approximately 1,400 new transportation employees this year. To-date, in 2022, we have graduated 486 employees and have an additional 504 currently in training, with almost 400 of those employees graduating by the end of the third quarter.

Although the hard work is not yet done, I am encouraged by the improvement already made. I would be remiss to not acknowledge the efforts and cooperation from all, to the operating and marketing and sales teams within UP, and most importantly, our customers. Our network is in a better state today because of these combined efforts. Now let's review our key performance metrics for the quarter, starting on slide 10.

The key performance measures for second quarter 2022 continue to trend below 2021 results. We did, however, strengthened freight car velocity as well as manifest and auto trip plan compliance sequentially as we moved through the quarter. Intermodal trip plan compliance continues to lag results from earlier in the year due to continued supply chain congestion resulting in increased container box dwell and elevated chassis street time. Our attention remains on increasing freight car velocity which will improve intermodal service performance, although the challenges associated with the supply chain will likely persist.

Turning now to slide 11, the network efficiency metrics for the quarter illustrate the impact of our network recovery actions. Since the beginning of the year, we have added locomotives to the network, which when coupled with lower train velocity, impacts locomotive productivity results for the quarter, declining 12% compared to 2021. As we anticipate volume growth heading into the second half of the year, locomotive productivity will improve with better fleet utilization as we move more carloads at a greater overall velocity.

Second quarter workforce productivity deteriorated slightly, down 2%, as car miles were essentially flat for the quarter while employee levels increased. Train length remains flat compared to one year ago. However, train length is up 3% sequentially. The team leveraged train length to improve crew utilization, aided by the completion

of 10 sidings to date in 2022. We continue to identify productivity opportunities as we build a more resilient and high-quality service product for our customers.

Wrapping up on slide 12, we remain committed to the goal of achieving world-class safety performance. The improvement in our employee incident metric provides evidence that the enhancements we made to our safety programs are beginning to take hold. While the derailment rates have not yet improved compared to 2021, we continue to educate our workforce to ultimately reduce variability and expense.

The swift and decisive initiatives implemented in April reduced congestion and sped up the network. An increase in crew supply will further support these recovery efforts. Looking forward to the second half of 2022, we plan to build on the momentum gained during the second quarter.

With that, I will turn it over to Jennifer to review our financial performance.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Thanks, Eric, and good morning. Let me start with a look at the walkdown of our second quarter operating ratio and earnings per share on slide 14. Union Pacific's earnings per share increased \$0.21 to \$2.93, and our quarterly operating ratio of 60.2% worsened by 510 basis points. Rapidly rising fuel prices throughout the quarter, the lag on our fuel surcharge programs, and the widening refining spreads negatively impacted our quarterly operating ratio by 130 basis points while adding \$0.18 to earnings per share.

Our operating ratio and EPS were further negatively impacted 380 basis points and \$0.02 per share, respectively, as core results reflect the impact of network recovery efforts that more than offset the benefits of our top line growth. Below the line, real estate sales and lower state tax rates netted to a year-over-year benefit of \$0.05 per share. We closed the second half with a land sale with the Illinois Tollway Authority which we announced in May, and then the State of Nebraska changed its corporate tax rate in the quarter.

Looking now at our second quarter income statement on slide 15, operating revenue totaled \$6.3 billion, up 14% versus 2021 on a 1% year-over-year volume decline. Operating expense increased 25% to \$3.8 billion. Excluding the impact of higher fuel prices, expenses were up 11% in the quarter. Second quarter operating income was \$2.5 billion, a 1% increase versus last year. Interest expense increased 12% compared to 2021, reflecting higher debt levels. Income tax decreased 2% due to the Nebraska corporate tax rate reduction I just mentioned, and contributing to lower second quarter effective tax rate. Net income of \$1.8 billion increased 2% versus 2021, which when combined with share repurchases, resulted in earnings per share up 8% to \$2.93.

Looking more closely at second quarter revenue, slide 16 provides a breakdown of our freight revenue which totaled \$5.8 billion, up 14% versus 2021. Lower year-over-year volume reduced revenue 150 basis points. Fuel surcharge revenue increased freight revenue 11.25 points, reflecting the rising diesel prices. Total fuel surcharge revenue was \$976 million in the quarter. Strong pricing gains, combined with a positive business mix, drove 425 basis points of freight revenue growth.

The significant decline in international intermodal volumes contributed positively to mix. However, the usually strong mix impact of year-over-year Industrial growth was muted by strength in short-haul [ph] rock (00:15:36) movements. Overall, the demand environment continues to support actions that yield price dollars exceeding inflation dollars. It's important to note, though, that our network recovery efforts limited our upside for both price and mix as we only count price if we move the cars.

Moving on to slide 17, which provides a summary of our second quarter operating expenses where the primary driver of the increased expense was fuel, up 89% on an 87% increase in fuel prices. We saw a dramatic rise in prices through the quarter, paying record highs as they surged from an average of \$3.71 per gallon in April to \$4.34 per gallon in June. Our fuel consumption rate was relatively flat compared to 2021 as negative productivity was partially offset by a more fuel efficient business mix.

Looking further at the expense lines, compensation and benefits expense was up 7% versus 2021. Second quarter workforce levels increased 2%. Management, engineering and mechanical workforces grew 1%, while train and engine crews were up 5%, primarily reflecting year-over-year increases in our training pipeline. As you heard from Eric, strong third quarter graduations position us to support our network recovery efforts and prepare for future growth.

Cost per employee increased 5% as a result of wage inflation and continued elevated costs relating to network inefficiencies that come in the form of higher re-crew, overtime and [ph] borrow-out (00:17:06) costs. For the balance of the year, we expect year-over-year increases to be sequentially lower from the second quarter in both the third and fourth quarters.

Purchased services and materials expense was up 30%, driven by higher costs to maintain a larger active locomotive fleet, inflation, and volume-related purchased transportation expense associated with our Loup subsidiary. We also had an unfavorable comparison in the quarter versus 2021, where we called out a \$35 million favorable onetime item.

Equipment and other rents grew 15%, driven by lower TTX equity income and increased car hire expense related to network congestion. Other expense grew 17% in the quarter, driven by a \$35 million increase in casualty expenses associated with adverse adjustments to older claims and increased business travel. For the full year, we now expect other expense to be up low-single digits versus 2021. Although fuel was clearly the driver of higher quarterly costs, the added expense from our service performance resulted in 69% fuel adjusted decremental margins.

Turning to slide 18 and our cash flows, cash from operations in the first half of 2022 decreased slightly to just under \$4.2 billion, down 1%. Our cash flow conversion rate was 73%, and free cash flow of \$1.1 billion declined \$727 million. This of course includes the impact of \$455 million increased cash capital spending and \$206 million in higher dividends. Capital spending year-to-date is up 38% versus 2021, which reflects both a more normalized spend trajectory and an increased capital budget for 2022.

Year-to-date, we returned \$5 billion to shareholders through dividends and share repurchases. This includes a 10% dividend payout increase announced in May, the third such increase in a little over a year's time. And we finished the second quarter with an adjusted debt-to-EBITDA ratio of 2.8 times as we continue to maintain a strong investment grade credit rating.

Wrapping up on slide 19, as we've discussed this morning, it was a difficult second quarter, but necessary to position ourselves for success in the second half of the year. Importantly, we're demonstrating greater network fluidity as evidenced by the metrics, and Kenny just described for you that there is still solid demand for our services despite some indications of economic softening.

For example, full year Industrial production is still forecasted at nearly 5%, but back half 2022 estimates are weaker. Against that backdrop, we expect to be back on track to exceed Industrial production in the second half of 2022 and produce full year carload growth of 4% to 5%.

As it relates to our operating ratio, the first half performance makes achievement of year-over-year improvement unlikely. However, we do expect year-over-year improvement in the second half of 2022, and a full year operating ratio around 58%. While our 2022 results won't match our view coming into the year, we remain committed to our goal of ultimately achieving a 55% operating ratio.

We're also revising our guidance for incremental margins which we now expect to be around 50% for the back half of the year. Beyond 2022, we still expect to achieve our longer-term guidance of mid- to upper-60% incremental margins.

Our capital allocation plans remain unchanged, capital spending at \$3.3 billion for the year, well within our long-term guidance of below 15% of revenue, and we remain committed to leading the industry with our long-term dividend payout ratio and share repurchases on par with 2021.

Finally, I feel fortunate to work with such a fantastic team of railroaders at Union Pacific. Every time I return from a field visit, I'm energized about the future of our company. Thanks to a great team, we have a bright future ahead.

So with that, I'll turn it back to Lance.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Thank you, Jennifer. Before my closing remarks, I want to briefly touch on a couple of topics. First, related to our sustainability efforts, we've made great progress to increase the use of renewable diesel and biodiesel in our locomotives. We're currently over 4% blended in our fuel usage, and on target to achieve our interim goal of a 10% blend by the 2025. This is a critical initiative for us to achieve our 2030 greenhouse gas emission reduction targets.

Second is a quick update on the status of our labor negotiations. Earlier this week, President Biden appointed a Presidential Emergency Board, and the board's proceedings begin this coming Sunday in Washington, D.C. All parties are anxious for a reasonable agreement. Our employees are long overdue for a wage increase. We're ready to put the uncertainty behind us and look forward to a resolution in the near future.

Now wrapping up, as you heard from Eric, we've made positive strides on safety in the first half of the year. I'm encouraged by the momentum that I see building within our safety [ph] crib (00:22:07) programs. Having said that, we're short of our goal of world-class performance, and that is our task ahead.

Our second quarter performance, both operationally and financially, did not reflect the best of Union Pacific, yet, we still achieved quarterly financial records. This reflects the great work we've done through PSR adoption the last several years to make our company more resilient, efficient and profitable.

Our focus over the next six months is to again demonstrate our ability to successfully grow volumes while improving and sustaining service levels. I am confident we will build that track record. These efforts are critical to our success in the back half of 2022 and beyond and are core to our long-term strategy to Serve, Grow, Win, Together.

With that, let's open up the line for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Thank you. And our first question today comes from the line of Justin Long with Stephens. Please proceed with your question.

Justin Long

Analyst, Stephens, Inc.

Q

Thanks, and good morning. I wanted to ask about the OR guidance. Back in early June, you made an adjustment and we're getting another adjustment today. So just curious what changed in the last month. Is this service related? Is it the economy? Maybe a little bit of both? And then just thinking about the quarterly cadence of the OR in the back half, is there any color you can provide on how you're thinking 3Q plays out relative to 4Q? Thanks.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. Well, let me start, Jennifer, and then maybe you finish us up. So Justin, clearly as the quarter progressed and as we exited the quarter and came to the third quarter, there's a few headwinds that either continued or didn't abate as we had expected.

So one is, while we are recovering the network, we had anticipated the pace being a little quicker, and more importantly, we had anticipated volume coming on sooner as the network improved. And getting the volume back is really the primary driver of improving our operating ratio and really shoring up the financials in total.

In addition, fuel didn't behave kind of like what we had hoped it would, and there were some other inflationary pressures that added to it. But I'd say those first points are the big points.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

And then I would also say, as we close out the quarter, you make some of those quarterly adjustments and you heard me reference the \$35 million casualty change. That obviously is a pretty big swing factor. But it's things like that as well as sequential improvement that we're seeing in our operations that gives us the confidence in how we're thinking about the back half of the year to have that improvement as we sequentially improve our operations, see volumes grow, that's going to help us produce those stronger financial metrics in the back half of 2022. So I think that's an important way to think about it, Justin.

Justin Long

Analyst, Stephens, Inc.

Q

Okay. And on the cadence in the back half, I guess the guidance basically implies that you go from a 60% OR in the first half to something around a 56% in the second. Do you expect it to be pretty even 3Q to 4Q?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

There's different factors in both. Certainly sequentially, as I mentioned, we're going to expect to improve. Obviously, you get into the fourth quarter, you tend to see lighter volume, you maybe can get some weather, so

we'll see exactly how that plays out. But what we're focused on is sequential improvement. You'll see improvement in the third quarter from the second quarter certainly. I don't know that you'll actually see year-over-year improvement in the third quarter. We think that's probably a little bit of a stretch, but certainly when you get to the fourth quarter, we're looking at year-over-year improvement all together, then too, in the second half.

Justin Long

Analyst, Stephens, Inc.

Got it. That's helpful. Thank you.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yeah. Thank you, Justin.

A

Operator: The next question comes from the line of Allison Poliniak with Wells Fargo. Please proceed with your question.

Allison Poliniak-Cusic

Analyst, Wells Fargo Securities LLC

Hi. Good morning. Just following along in Justin's line of commentary, in terms of that incremental, it sounded like the volume piece was the bigger contributor. So I'm just trying to understand between service and volume improvement kind of what you need to see there to get that incremental margin in the back half. Just any more color there.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yeah. So I'll start, Allison. What we need to see is exactly what we outlined earlier this morning, and that is continued improvement in our service product so that we can both spool up existing assets like grain shuttles, which will generate more loads and very attractive loads in the grain world, as well as bring on more assets that can get more loads for us like coal sets or private cars or system cars. So bottom line is, what we really need to pay attention to is, are we seeing car velocity improve, are we seeing excess inventory continue to exit the network, and are we seeing our locomotive utilization and overall utilization of our assets improve, because that will generate basically what we need to have happen.

A

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah, which is more carloads to leverage against that asset.

A

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Correct. Yeah.

A

Allison Poliniak-Cusic

Analyst, Wells Fargo Securities LLC

Got it. And then just in line with that volume, I know Kenny said there was a volume impact obviously from the metering. Any thought, any way you can quantify what that impact was, so assuming that's going to come back online in the second half?

Q

Kenny Rucker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

Yeah. Allison, the way we look at it and think about it is if you look at where we were in the first quarter, we were up, call it, 4%. We would have expected that sort of a run rate going into the second quarter. So if you have to frame it, you should frame it in that light.

A

Allison Poliniak-Cusic

Analyst, Wells Fargo Securities LLC

Great. Thank you.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Thank you.

A

Operator: The next question is from the line of Tom Wadewitz with UBS. Please proceed with your question.

Thomas Wadewitz

Analyst, UBS Securities LLC

Yeah. Good morning. Wanted to ask about I think purchased services costs which seemed pretty elevated, and I wonder if there is – were there kind of transitional costs, one-off type of costs, you'd have good visibility to that improving in the second half. Just maybe some thoughts on that and kind of how we think about network efficiency improving affecting how we look at operating costs in second half. Thank you.

Q

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Sure. Yeah. In terms of the purchased services, you're right, it was elevated. One thing to remember is we did have a \$35 million good guy last year, so that's part of that year-over-year comparison. But as we're bringing more locomotives on, that certainly – there's a cost to maintain that larger fleet. You saw the locomotive productivity numbers that Eric showed, so that really is an opportunity in the second half.

A

And then also, when you think about our Loup subsidiary and the purchased transportation [ph] costs that we're (00:29:46) seeing, particularly the automotive business come back on which is a big part of their business, that's where you see some of that purchased transportation flow through is in that purchased services line.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Eric, maybe you want to – because I heard in Tom's question costs that existed in the second quarter and how they come out in the third and fourth.

A

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

Yeah. Absolutely. So picking up where Jennifer left off, the customer focused on most right now, it all relates to that gain in velocity that we demonstrated in the second quarter. The opportunity we see in the immediate future is on the locomotive side. If you look back on our first quarter earnings report, we reported adding in about 150 locomotives. We've been working just in the last two weeks to start to reverse that and be very thoughtful about

A

taking that out. We want to make sure that those get put into our at-the-ready status so that we can continue to adjust for variability but also be able to meet the second half growth forecast. So that's a big opportunity for us, Lance.

Thomas Wadewitz

Analyst, UBS Securities LLC

Okay. Great. Thank you.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Thank you, Tom.

A

Operator: The next question is from the line of Scott Group with Wolfe Research. Please proceed with your question.

Scott H. Group

Analyst, Wolfe Research LLC

Hey, thanks. Good morning, guys. I want to ask just a bigger picture question. I think some people are questioning the success or maybe the sustainability of PSR, and if you look in 2Q, your head count from pre-PSR is down kind of 25%, 30%, volume is down about 7%. Is there some potential that you need to get that head count back closer to those pre-PSR levels to get the service back? And I guess I want to understand what you think this means for the OR that we were supposed to do a 55% this year on our way to a lower – low to mid-50s OR in a couple years. Are those just the wrong numbers to be thinking about now for the OR over time?

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yeah. Scott, let me start first by saying emphatically that PSR is not the cause of our problems in the second quarter. When you look at our pre-transformation to today, look, all of that head count change is because we took work out of the network. We ran one-third fewer trains which require one-third fewer locomotives and also one-third fewer people running the trains and maintaining the locomotives.

A

So we took work out of the network that didn't need to be there because we were touching cars more than we needed to and we had too many special commodity unit trains running around the network. So we transformed the network, took that out, and we were in fine shape. We're the same railroad that we were in 2021 or 2020 I mean, but here's where we got into trouble. We ran the network tight and we did not recognize the stack up of risks that were in front of us with COVID continuing to impact crew availability, growth coming on and normal weather events. When you run tight, you just don't have a lot of opportunity to recover quickly. We got into trouble, and inventory grew on us and we had to take some pretty significant measures to fix that. And we did in the second quarter.

When you look at what we need to do different going forward, it's not thousands of employees different, it's hundreds and in different ways. We've got to get our [ph] ops boards (00:33:21) back, we've got to run our boards less tight than we were running them for a while, and we've got to do some other unique and creative things with our labor unions in order to make our crews more available and more productive without them working harder. And that can be done. We see a clear path for all of that.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

But to the other part of your question about, does that mean 55% is off the table, absolutely not. We absolutely believe we have the opportunity to have that 55% OR as we restore our service, bring the volumes back on, as well as the incremental margin target. So that has not changed for us, Scott.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

100%.

Scott H. Group

Analyst, Wolfe Research LLC

Q

Okay. Very helpful. And just Lance, your comments were helpful. Do you think getting a labor deal done in the next couple months is going to be a help here?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. What's going to be a help about that, Scott, is it takes off the table all the anxiety and conflict of a labor force that hasn't seen a raise in two-and-a-half or three years, and you put that to bed and then we can get busy on deals that we care about on property, which are really, really important to us.

Scott H. Group

Analyst, Wolfe Research LLC

Q

Thank you, guys.

Operator: The next question is from the line of Amit Mehrotra with Deutsche Bank. Please proceed with your question.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Thanks, operator. Hi, everybody. Jennifer, I just want to understand what's embedded in the back half guidance or the revised full year guidance, because this is now the second time in, I don't know, 40, 45 days that we're revising the full year outlook. And so I just think it would be helpful to understand, if we look at the back half guidance, how much implied service inflection is there? Because Kenny and Eric's team have done a good job kind of addressing the biggest issues early in the quarter, and we've seen a big bounce on service. And so what I want to understand is, if we stay where we are off this improved level, is that enough to get to the back half guidance or embedded in that is a further improvement in service and car miles and things like that? If you can just address that, that would be helpful.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Sure. So two things. I mean, you're absolutely right, we have seen a very good rebound in terms of where we were, call it, from the middle of April to where we are today. So we're entering the third quarter in a much better posture than we entered the second quarter and feel good about that. But for us to be able to achieve these targets, we do need to continue to improve, and I think you've heard that from us. We need to continue to improve

the fluidity of the network. That means using the assets more effectively, using our crew base better, getting more utilization out of the locomotives. You heard Eric talk about that. Those flow directly to the income statement. You think about comp and benefits, you think about our purchased services, but then we need the volume leverage on top of that. And so those are the things that we're looking at. You get those markers from us every week, so you'll be able to track that progress. But we do need to improve from where we sit today to hit the second half targets.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. Jennifer, putting a finer point, Amit, I think what we've talked about is, with the STB and others, we need to see that car velocity start with a 2 – the 200-type number in the back half of the year. And with that, you'll see most of the other metrics move in the right direction.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Lance, just related to that, given how important it is to get to that 200-plus car mile velocity per day, there are a few people out there that have many decades of PSR experience that have seen PSR implemented in not just an upcycle but a downcycle and etcetera. Those guys seem to be available on a consultancy basis. I don't know if there is scope to bring in somebody on a short-term basis to accelerate some of the progress that you've already made or Eric's team's already made on the service levels. Is that something that you're considering or looking at doing?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Actually, Amit, we remain in conversation with all of the contacts that we've created through our PSR journey, and really, they're helpful, but we don't learn anything necessarily new, right? The issue is aggressively implementing the recovery plan, which we did through the second quarter, demonstrated the movement, and keeping that movement up. So, yeah, fundamentally the approach doesn't change and we've got the team that can make that happen.

Amit Mehrotra

Analyst, Deutsche Bank Securities, Inc.

Q

Sure. Okay. Very good. Thank you very much. Appreciate it.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

You're welcome.

Operator: Our next question is from the line of Bascome Majors with Susquehanna. Please proceed with your question.

Bascome Majors

Analyst, Susquehanna Financial Group LLLP

Q

Jennifer, and maybe Lance, there's obviously some uncertainty as to what the actual union wage increases from 2024 are ultimately going to be. Can you share how UP has managed that uncertainty with your accruals so far? And if actual wages were to come in different than those expectations, when do you true that up retroactively and communicate it to people like us prospectively?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Jennifer, let me start by talking about wage increases and what we could see, and then you can kind of talk about how we've accrued, etcetera.

So Bascome, the PEB is going to listen to both sides and then come up with what they think is a reasonable approach to wages. Recall that our package is going to include 2020, 2021, 2022, 2023 and 2024. And in 2020 and 2021, the markets were tough for wages, right? In 2020, wage growth was probably near zero. 2021 it accelerated. It's accelerating in 2022, and I expect it's probably going to be relatively strong in 2023 before dropping back down.

So we've got a good beat on that. We've got a proposal that we'll be talking to the PEB that reflects that, and I think that the PEB is reasonable and they appear to be knowledgeable and skilled as arbitrators. We'll get to a place that we're comfortable with.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. Bascome, and in terms of timing, so once there's an agreement and we know what those numbers are, we will recognize anything that reflects the backward looking piece immediately, if there is anything different there that we need to recognize. In terms of what we're accruing, we're obviously paying attention to the markets, the negotiations, and we're keeping pace with that as we look to make those accruals. So we will true-up if needed at the time of the agreement.

Bascome Majors

Analyst, Susquehanna Financial Group LLLP

Q

So thank you for both of that. Lance, just to double check here, it sounds like you're anticipating at least a proposal from the rails, anticipating a lower inflation environment in 2021, maybe a higher one in 2022, 2023 and some normalization after that. Is that reasonable to think your accruals would directionally reflect that?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

It's reasonable to think our proposal in front of the PEB reflects that, for sure.

Bascome Majors

Analyst, Susquehanna Financial Group LLLP

Q

Thank you, both.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes.

Operator: The next question is from the line of Chris Wetherbee with Citi. Please proceed with your question.

Chris Wetherbee

Analyst, Citigroup Global Markets, Inc.

Q

Hey, great. Thanks. Good morning. I guess as we're thinking about sort of the cadence of volume picking up in the back half of the year, so obviously it's related to service, but – and maybe Kenny, could we go through some of the segments where you maybe have good visibility to that if there are some incremental changes in the service product that you're offering, you can see a direct result from volume? Because I think service has been improving here. I'm not sure we've necessarily seen the commensurate improvement in the weekly carloads. So just want to get a sense of maybe some specific points where you feel like, yes, there's an opportunity coming there, we just need a little bit better product to be able to kind of serve the market.

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. Thanks, Chris. Let's just walk you through all the markets here. If you look at our Bulk business, we talked about our grain business. We've had a couple good years on the grain side, and clearly there is a lot of demand on the export side. So tough comparison versus last year in the fourth quarter, but the demand is there and we know that the crop is there also, which has given us a lot of confidence. On the coal side, you all see the same metrics that I see in terms of natural gas prices. Those are going to be strong for sure throughout the rest of this year, probably well into 2023. On the fertilizer side, there's still a lot of demand on the export fertilizer side.

And then one of the things, as I go to Industrial and leave food and refrigerated, Eric and I have been working closely together during the second part of the quarter add a few more of our system cars in, here, recently in July, we're adding a few more cars in. And so as you look at places like metals where we have wins, if you look at some new business that we have coming on with industrial chemicals and plastics, even lumber is an area that I know there is a lot of mixed media out there, but the demand is still pretty strong and that car supply will be there too.

So you look at that and then you transition over to our Premium area, where again, we've got a new private asset on our railroad and domestic intermodal will still be stable to strong. And then, on the automotive side, dealer inventory is still low. It's still at 25 days and we expect, and we've been talking to a lot of our customers, that they're going to get a better, stronger supply of semiconductor chips and there's a lot of pent-up demand there. So the way I look at it, I'm very optimistic about the demand being there and our commercial team being able to win new business to bring it on.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

And Eric, it's all about running the networks so that we can capture as much of that as possible.

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

A

Yeah. That's exactly right. When you think about car velocity and you think about service, they're tied together. And so when we think about our biggest opportunity sitting right in front of us, it's really about crew availability. And we've got some growing tailwinds. We've gotten through the third and fourth most impactful holiday of the year. Now that Father's Day and Fourth of July is behind us, we saw sequential improvement month after month during the entire quarter in our re-crew rate that generates additional crews for our use. And then of course we've got the hiring that I covered in my prepared comments that bring me a tremendous amount of confidence, especially because 400 of the 500 that are currently training will be available to us by the end of the third quarter. So all growing tailwinds to be able to increase velocity and deliver the service product that our customers expect.

Chris Wetherbee

Analyst, Citigroup Global Markets, Inc.

Q

I appreciate that. Maybe one quick clarification. Just international intermodal, is there something that is sort of outside of your control in terms of whether it's customers picking up ports, warehouses having the wrong inventory that's creating a log jam, that's creating some of the issues that we hear very publicly about in terms of dwell on the dock in LA Long Beach, or is there something else going on there?

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

A

Sure. So let's back up and look at the entire supply chain on that. If you start in the West ports and you look at the current total box count, clearly it's as high if not higher than it was last year. What we're focused on besides just the West ports is the inland terminals. What you want to make sure you do is ensure that those inland terminals can remain fluid, right? Thinking about Chicago again last year. We don't want to get to the point where we've got an excessive number of trains holding outside of Chicago. And to be clear, for this entire quarter we haven't had that. We've remained fluid in Chicago.

What's driving that is the increased chassis time which turns into a lack of chassis to be able to generate back to the West Coast to be able to keep the system entirely fluid. So as I look at the network right now, we're prioritizing correctly [ph] so for our (00:45:49) customers' fluidity inside of our intermodal terminal and we need continued improvement on external factors to keep driving the entire supply chain to get better.

But, Kenny, you may want to add something.

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. Just you and your team are doing a great job of controlling what you can control. We don't have control over the international chassis. And so we're working with our customers to make sure that they can get as much efficiency from their own [ph] chassis as (00:46:16) possible.

Chris Wetherbee

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks very much. Appreciate it.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thanks, Chris.

Operator: The next question is from the line of Walter Spracklin with RBC Capital Markets. Please proceed with your question.

Walter Spracklin

Analyst, RBC Dominion Securities, Inc.

Q

Yeah. Thanks very much. Good morning, everyone. So I want to focus on back on the metering and embargoing of traffic. I know your Eastern peer yesterday quantified that as kind of a measure of last resort and very extreme in nature. And my question I guess is whether are you being more impacted than your peers from structural – the

structural occurrence of the supply chain issues, and perhaps if you can characterize that relative to your closest peer, BNSF, if they're going through kind of a similar experience.

What I'm trying to assess here is the potential for share loss once things moderate, and obviously there's some customer dislocation here and whether when things moderate that will come back to bite you at all. I know CP-KC is going to bring on new competition next year as well. So any color on where you stand relative to your peers, and whether you feel that your return to a better service is matching that of your peers, lagging, or are you coming ahead those of your peers in terms of that recovery?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. So, Walter, you can see the data for yourself. Our recovery since April has led the peer group, the US railroads. Certainly, it's led in the West. So our statistics would tell you that we're recovering, and I'm sure all of our peers are working hard to recover as well, and we are not dissatisfied with our pace at this point.

In terms of how we use embargoes, it's evident. If you look at the STB, we use embargoes more than our peer railroads do. And the way we use them is very targeted to a particular destination receiver that is not controlling their inbound volumes. And when our serving yard for that receiver indicates that we've got way more inventory both en route and on end than they can handle in a reasonable period of time, that's when we use embargo.

So we use it more than our peers do. I'm not sure why they don't, but it's a very effective tool for that purpose.

Kenny?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. Yeah. I mean, you hit it on the head, Lance. I just want to first start off by saying we make unilateral decisions about how we approach the customers, and so we're not looking at what someone is doing in the East or the West. And I've got to thank our customers, they were right there with us during our process to work through metering the traffic. Eric, you and your team did a really good job of us working together, providing customers with quantifiable data for where we thought they should be for getting the excess inventory out of line.

Those conversations, I don't want to downplay it, they weren't – some of them were difficult, I think the telltale for us are the results. We have had some really strong wins coming out of RFPs, bids, competitive bids where we won, incremental bids, and so when we look at it that way, some of the same customers that we had to have these difficult conversations with, we've turned those into positives and incremental volume. So that tells you that, again, we have a really focused and deliberate approach with our customers.

Walter Spracklin

Analyst, RBC Dominion Securities, Inc.

Q

Very encouraging. Appreciate that color. Thank you.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thank you, Walter.

Operator: The next question comes from the line of Brian Ossenbeck with JPMorgan. Please proceed with your question.

Brian P. Ossenbeck

Analyst, JPMorgan Securities LLC

Q

Hey, good morning. Thanks for taking the question. So, Eric, you mentioned that the hiring trends are up. Wanted to hear a little bit more about retention. We've seen just recently a couple of announcements from the East bumping up the pay for I guess new contractors – or new conductors, rather, getting qualified. So is that something that you can similarly do or looking at doing?

And then for Kenny, maybe one more thing in that bucket of things you can't control. Can you just talk more broadly about AB5 and whether or not that's going to have some sort of impact on the ports, supply chains, and if that affects your IMC partners in any way, if that does end up getting implemented?

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

A

Yeah. Brian, I'll start. Thanks for that question. As you know, our goal this year in total is to bring on 1,400 transportation employees, and as I said in my prepared comments, we're well on our way to do that. Specific to your comment around, are you seeing increased retention issues or washouts, we're really not. Both of our rates would be in line with our historical performance.

Now, we've done a number of different things around the hiring that's helped to ensure that that's the case. When we went back and you look at the beginning of the year with some of the changes we made to our training program that in some cases extending parts of it, that was to ensure that the quality of the training program was exactly what our employees needed.

At the same time, even just in the last two weeks we've offered up a new program where for our new hires we're actually engaging them to see if they actually want to go work in other locations than they may have otherwise been hired on, and that's providing flexibility that historically we may not have. So we continue to challenge ourselves between the operating team and our workforce resources group to incentivize our new hires to stay with us. We want them to be the 30-year-plus employees that we've got across the entire system.

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. So on your question about AB5, I'd say it's just too soon right now and it's a little unclear on the impact. And you're right on, we've been talking to a number of our IMCs out there and they're saying the same thing. I mean, a few of them have some of these owner operators, contractors, but it's just too soon and a little bit unclear to see what that impact will be.

Brian P. Ossenbeck

Analyst, JPMorgan Securities LLC

Q

Okay. Guys, thanks for the time. Appreciate it.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thank you, Brian.

Operator: The next question is coming from the line of Jon Chappell with Evercore ISI. Please proceed with your question.

Jonathan Chappell

Analyst, Evercore Group LLC

Q

Thank you. Good morning. Kenny, I think at the beginning of this year there was a lot of optimism on the intermodal side adding Swift, adding Schneider next year, improved supply chain, tight truck market, etcetera. As you think about on-boarding Schneider next year and combining that with some of the service issues we've spoken about and the recovery plan, do you feel that you're appropriately resourced to meet the growth targets that you were expecting by on-boarding these two huge customers and given some of the macro dynamics that should be supportive to intermodal, or do you need to scale back some of your expectations in the medium term?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

No. I mean, I want to start off by saying that the management team here has really done a great job of being deliberate about our capital expenditures. We've talked about the \$600 million that's going to help us with additional rail sidings, with commercial facilities, and I do want to say that this will help all of our intermodal network. So, yes, we're excited about Schneider coming on, but we've got a strong stable when you look at [ph] Hub (00:53:50), Knight-Swift and XPO and some of the IMCs that we have, all of them, the entire network will benefit from it. Eric and I and our teams are just – we've got a really rigorous process, planning process, and we feel good about the investments that we're making and the ability to on-board those new customers and actually grow with the existing customers.

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

A

Yeah. I'll echo the exact same confidence. As you think about what the operating department and the marketing and sales department are doing together, the last six months of Knight-Swift, which has done exceptionally well, that's our continued playbook with Schneider. We're making sure that we take every one of those plays and applying them to Schneider.

I'll also echo Kenny's comment about how we think about investment. Kenny, you hit on the infrastructure, we're also doing a lot on the technology side, and it doesn't just benefit Schneider, it benefits all of our customers. If you think about the work just in the last month toward now through our UPGo app, we're getting about 10,000 comments back from drivers on our intermodal ramps. Those comments range from ideas to improve to things that they think are going really well. It's that type of feedback that we can continue to ensure that we're making our ramps as efficient as possible from a driver's experience for all of our customers. So I'm very excited, very confident.

Jonathan Chappell

Analyst, Evercore Group LLC

Q

Okay. Thank you, Eric. Thanks, Kenny.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah.

Operator: Our next question is from the line of Ken Hoexter with Bank of America. Please proceed with your question.

Ken Hoexter

Analyst, BofA Securities, Inc.

Q

Hey, great. Good morning. Maybe seems like some momentum you talked about in the latter part of the quarter, but, Kenny, volumes were up 1% quarter to date here, almost one month through the quarter. And with about 1% average growth in the first half of the year, just to get to the 4% to 5% growth Jen was talking about seems like you'd have to quickly ramp to upper single digits, especially given the trend of nearly one-third of the quarter in the bag. So maybe, Kenny, you also mentioned the drop in spot rates in trucking, maybe could you just revisit that for a bit and maybe walk us through where we should see that rapid ramp?

And then, Lance, from your perspective in your seat, I mean, I guess we're kind of even something that some of us haven't seen with inflationary backdrop that hasn't been around for 40 years, how do you think about that in terms of managing the rail and how to adjust?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. First off, and Eric talked a little bit about this, coming out of Fourth of July holiday certainly puts us in a ramp-up capacity or a ramp-up scenario. The other part of that is, and I mentioned this, is that we are adding on more resources, meaning we are adding in more of the system cars onto our network, and so that's given us a lot more confidence there.

And then you mentioned the spot rates and we've got to differentiate the spot rate that we've seen go down versus these contracted rates. We still see that there's a firmness in those contracted rates and there's a lot to that and a lot of reasons why. I mean, there's still a number of truckers that need to be hired and that's in the tens of thousands. We've seen chassis dwell increase. We've seen container dwell increase. So there's still tightness there, and as our service is improving, we're going to be pricing and we are pricing right now for that service improvement, especially during all the tightness that we're seeing.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Ken, and fundamentally you're right, we do need to accelerate volumes into the third quarter, and we will. We're confident that, that will be happening and is starting. In terms of inflation, also correct. It's a unique environment, right, when you start seeing CPI in the 9%-plus range. It's been a long, long time since we've seen that, and probably most of our management team up and down the org chart hasn't experienced that before.

What we're doing to deal with that is just being relentless on productivity and efficiency, notwithstanding what you saw in the second quarter which was all about recovery and adding the necessary resources and experiencing the necessary costs to recover more quickly than we would otherwise. But overarching that, there's just a relentless use of technology and process improvement to get productivity out of the network.

And one of the things that's helping us directly with purchased inflation is the wave process that our supply chain team goes through. We're on our – I want to say wave 11 right now, where we take a chunk of our spend and basically deconstruct it with should-cost analysis or benchmark analysis and then negotiate with our primary suppliers and looking for new suppliers that can help us find cost reduction, total cost of ownership. And that saved us hundreds and hundreds of millions of dollars over the last handful of years and that's cumulative as we

look forward. So, yeah, you do have to do different things, Ken, and it's a unique environment, right, and it doesn't look like it's going to go away anytime soon.

Ken Hoexter

Analyst, BofA Securities, Inc.

Q

Lance, if I can just clarify one thing. I guess through this call, it's not just a – I guess from a UP perspective, this is not just about employees as we heard about last night from an Eastern rail. I guess you still see this as a lot of operational improvement that you control, and I guess from Eric's point of view it's not just about adding head count. Am I hearing that right?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. Ken, I think you're hearing it mostly right. Primarily, we do have to get crew availability which is about hiring and hiring in the right spot to get back to being completely fluid. So that's an important element. In addition to that, though, you can see in our metrics, terminals are in generally pretty good shape. Terminal dwell is good and there's portions of the network that are operating pretty darn well. We've got to get over the road more effectively. That starts with crew availability but there are other things that are built into that, that can help, like continuing to [ph] deduce (01:00:09) variability events and derailments, things like that.

Ken Hoexter

Analyst, BofA Securities, Inc.

Q

Thanks for the time. Appreciate the thoughts.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thank you, Ken.

Operator: The next question is from the line of Jason Seidl with Cowen. Please proceed with your question.

Jason H. Seidl

Analyst, Cowen & Co. LLC

Q

Thanks, operator. Lance and team, good morning. Wanted to talk a little bit more on the domestic intermodal side. You mentioned, Kenny, I think that you're keeping a close eye on sort of the declining spot truckload rates and maybe the impact it might have on domestic intermodal. How should we think about the yields in the back half of the year as we look to model?

Kenny Rucker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Well, we're 80% through our RFP season and so the prices and increases that we've taken, you're going to see those reflect as the volume improves in domestic intermodal. Again, we're going to watch it but it's just not showing up right now on the contracted side. It's still a very tight supply chain. We'd like to see a few things loosen up in terms of the chassis dwell that's out there and the container dwell to help with the volume and us capture more of that volume that's out there. But again, there's still a disconnect there between what we're seeing on the spot side and the contractual rates.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

And Kenny, I mean that's just reflective of the fact that in our contracted world, we chase pricing different than you see the rapid price changes in truck. So that while truck spot rates flew up and are now starting to drop back down, we're still in a kind of a catch-up phase, if you will.

Jason H. Seidl

Analyst, Cowen & Co. LLC

Q

And as we look at 4Q, last 4Q we were sort of at the height or the height of the worry about the supply chain. There was probably a lot of accessorial charges that a lot of different carriers on the rail or trucking side was adding on. How should we think about that this year as we look to the year-over-year comparisons for 4Q yield in general?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. Jason, I mean, you're right, we had seen some elevation in some of those ancillary revenue items because of supply chain, and as we talked kind of at the beginning of the year, then I would say we still see this today. There's opportunities for that to improve in the back half of the year, assuming the supply chain improves as well. So we're watching that. It hasn't changed much I would say here in the first half, but would look for some improvement in the back half.

I should also mention relative to yields in the back half, we are expecting a little bit more of a negative mix impact in the back half as we see those international and domestic intermodal loadings pick up relative to some of the rest of the business groups. So something else to consider.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

And all of that's embedded in [ph] the slides (01:03:00).

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Oh, yeah. Absolutely. And that's consistent with how we kind of saw the year playing out relative to mix even back in January.

Jason H. Seidl

Analyst, Cowen & Co. LLC

Q

Okay. Appreciate the color, everyone. Thank you for the time.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thank you, Jason.

Operator: Our next question is from the line of Ben Nolan with Stifel. Please proceed with your question.

Benjamin Joel Nolan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Thanks. So when you talk about certainly the carload growth in the back half of the year, but then Kenny I think you also said that you're expecting incremental growth in 2023. Just curious what kind of broader macroeconomic assumptions that takes into account, and really is it – are you able to just sort of play catch-up on the carload side even if the broader macroeconomic environment were to decline a little bit, or how sensitive would that growth be?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. I mean, a lot of this is not being able to catch up with [ph] mixed volume (01:03:57). I mean, there probably is some low inventories that will replenish on the coal side. But again, the fundamentals for natural gas prices, we expect to remain pretty strong into 2023. The same is true with some of the commodities like finished vehicles and auto parts.

But layered on all of these are really business development wins. So I can point to business development wins on finished vehicles that were over the road. Business development wins on auto parts that were over the road. And then, again, same is true with our plastics business and our metals business. These are new business wins that are coming on. So that's how I think about it when I'm looking at Industrial production as a whole and where we stand and what's out there for us to capture.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. And Ben, regarding kind of what could happen in a recession, I've been talking to a lot of our customers across the different markets, and those that are big multinationals and global, their overall outlook is clouded by the fact that Europe is definitely slowing down pretty dramatically. China is in a bad place right now. And they look to the United States markets and they think, that hasn't happened in the US yet, and the impact in commodities that we ship, if a downturn were to occur, might not be as strong as it would be otherwise in a recession. Because in recessions in commodities you get this bullwhip effect, right, where there's not just in demand destruction, there's destocking that occurs. A lot of our markets, there's not destocking to occur because they're still trying to catch up on their supply chain stocking issues.

So it's just hard to say, Ben. We've been really trying to parse that out ourselves. And so far, we think that if the US economy slows down, let's say it is slowing down, I think our markets are going to be in a place where we're still going to have growth opportunity.

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Absolutely.

Benjamin Joel Nolan

Analyst, Stifel, Nicolaus & Co., Inc.

Q

All right. That's tremendously helpful. Thank you.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes.

Operator: Our next question is from the line of Ravi Shanker with Morgan Stanley. Please proceed with your question.

Ravi Shanker

Analyst, Morgan Stanley & Co. LLC

Q

Thanks. Good morning, everyone. Just a follow-up here on the domestic intermodal commentary. Look, I think I completely hear you on the yield differences between you and the truck spot market, but I think the broad consensus, including from trucking companies, is that the truck market is loosening here and will into the back half of the year. So kind of when you said earlier that some of these IMC switches between you and your primary competitor are going to be good for everyone, that implies the potential for significant truckload conversion the back half of the year, kind of what drives that uptick in truck conversion at a time when truck rates really should be falling in the back half?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

Yeah. So remember, we do have a new customer that we're excited about that's on our property now with Knight-Swift and we're seeing benefits and wins from there. As our service product improves, we also expect to insert more resources out there to win over the road. We also know that there's over the road business that can come back to us on the parcel side. So again, if you look across the spectrum, there's still opportunities out there as our service improves, as we add a few more of those resources into the network to grow this business in the second half.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

And I think the other thing, Ravi, just to remember is there's a big fuel delta between rail and trucks, and so certainly fuel has an impact on our margins but it has an even larger impact in terms of that cost for people who are shipping by truck. And then longer term, there's the ESG benefit that you've heard us talk about. And so while that's maybe not shifting the needle much today, longer term we still think that's a huge opportunity for us.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Right. But going back to your question, Ravi, I'm not sure Kenny that your requirement to the back half is some kind of rapid acceleration in truck conversion. You just keep on the path you're on, we get our service product continuing to improve, and what we need to have happen is happening.

Ravi Shanker

Analyst, Morgan Stanley & Co. LLC

Q

Very helpful. Thanks for the color. And just one quick follow-up. Lance, I think there was some chatter about Congress trying to mandate one-person crews for the railroads. Kind of any comment on that?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. So I don't know of Congress getting involved. They frequently get asked to get involved in the crew size discussion. Our role right now inside of national negotiation is to make sure that either the PEB addresses the

question or they address the question by allowing the railroads and labor to continue to negotiate, which we are right now with our unions that are affected on redeploying the conductor from the cab to the ground. We think it's better for the conductor's quality of life, there will be great jobs, and of course there is an efficiency opportunity there. And so we're going to keep pursuing that.

So, yeah, stay tuned. I think the next big thing that will happen is the STB is pending a rule that they've been working on regarding how many people have to be in the cab of a locomotive, and we've got our antenna up on that.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

I think you mean FRA.

A

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

FRA. Excuse me. Did I say STB? I'm sorry. I meant FRA.

A

Ravi Shanker

Analyst, Morgan Stanley & Co. LLC

Very helpful. Thanks, everyone.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yes. Thank you.

A

Operator: The next question is from the line of Jordan Alliger with Goldman Sachs. Please proceed with your question.

Jordan Alliger

Analyst, Goldman Sachs & Co. LLC

Yeah. Hi. This may be a little redundant, you've probably answered it multiple parts, but in terms of the volume acceleration to sort of high-single digit in the back half of the year, I'm just – to go from basically 1% to that, just trying to get a sense for how quick volumes can react. And I guess the question is, I know you have opportunity besides the economy and head count's important, but when you think about all together, whether it be the economy, head count, operational changes, what has to happen like first and today in order to be able to get that acceleration to the level that you expect? Because all the things together seem like they need to happen, but I don't know, it's just a big ramp and I'm just trying to understand which is the most critical components to it. Thanks.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Sure. Jordan, this is Lance. So I'll take you back as recently as June where you saw seven to eight carloads at the beginning of the month in the high 150s, 160 ballpark in the month at 165, 166. So that kind of ramp can happen, will happen, does happen on the railroad, and we're capable of it. We just did it. And by the way, during June, our service product was improving through that whole month. So we grew and improved service at the same time.

A

In terms of what makes that happen, number one, we have to have crew availability so we can run trains on demand. That's not just crews being graduated, which they are every week right now, but it's also making sure our re-crew rate's in the right place and that we're using every crew wisely, and that's in the right place. Our re-crew rates down, first starts are much more efficient.

There's still a lot of room to run on both of those. So that's the first thing that has to happen. And then after that, it's all the pick and shovel work of running a much better network from a reliability and a variability perspective. Right now, the good points are terminals are in good shape, we're launching on time on average all of our network, and what we have to do now is get over the road better and that's really about crew availability and variability.

Jordan Alliger

Analyst, Goldman Sachs & Co. LLC

Thank you.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yes. Thank you.

A

Operator: The next question is from the line of Jeff Kauffman with Vertical Research. Please proceed with your question.

Jeffrey Kauffman

Analyst, Vertical Research Partners LLC

Thank you very much. I appreciate you squeezing me in. It's been a long call, so I'll be quick.

Q

You noted that you had jumped on hiring and raising your T&E employee training a little sooner I think than some other rails. CSX was griping last night about how they're having attrition issues after training. Norfolk just put a release this morning saying they're raising pay to \$25 an hour and adding incentives. When I talk to rail industry people that are hiring, they say this is Gen Z. They don't want to work five days a week, they don't want to be on call before going out in the field. Can you talk a little bit about how the job is changing or what you've done to be maybe a little more successful in hiring and retaining your employees than some of the stories we're hearing?

Eric J. Gehringer

Executive Vice President-Operations, Union Pacific Corp.

Sure, Jeff. Let me take that one. I just want to make sure we level set on kind of your opening. So we started hiring back in April of last year. We hired approximately about 250 transportation employees as well as mechanical engineering last year, and then we built on that success this year. And as I reported this morning, we remain extremely confident that we can hire the 1,400 transportation employees we need to.

A

Now, as part of the job, I'm going to tell you that I think we're about halfway through that journey. Certainly the last two to three years as we've looked at how do you attract people to the railroad, we've relied on things that have proven to work in the past. So our implementation of an employee referral program, making sure that we're getting the word out inside of our own families and friends. Because those people best understand what the railroad really asks of you. They come in day one understanding those expectations. At the same time, our workforce resource group has done a phenomenal job being in different technical colleges to continue to draw

upon people from there with different scholarships, but they're also inside of that helping to achieve our goals for minority and for women joining the railroad.

Now, here's what's left, right? What's left – Lance hit on part of it, certain jobs today if you can take them from a relatively unscheduled process or unscheduled nonstandard schedule and move them to a more standard schedule, you're, one, going to improve the retention of the employees you have now; and two, you're going to offer up jobs that have been different than in the past, and in doing so, you're going to attract different groups of people than you may have been able to attract in the past.

So that's the work we have in front of us. Even just the two weeks ago we launched a new survey to all of our transportation employees to help them further help us understand quality of life on the job. So you'll continue to see us focus on it. We are not struggling as much as maybe some other roads, as you characterize it, but it's still an opportunity we have to keep at the forefront of us.

Jeffrey Kauffman

Analyst, Vertical Research Partners LLC

Thank you very much.

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yes. Thank you, Jeff.

A

Operator: The next question is from the line of David Vernon with Bernstein. Please proceed with your question.

David Vernon

Analyst, Sanford C. Bernstein & Co. LLC

Hey, guys. Good morning, and thanks for taking the time. Lance and Kenny, bigger picture question for you on intermodal. You guys have put forward service recovery plans to the STB that are targeting kind of return to low 60s I think on time performance in the intermodal business. I wanted to get a sense from you guys, why is that the right number? It seems like a fairly, I don't know, not a particularly aspirational set of targets. And is there a way that you guys could be thinking about that business differently that would give you maybe a better advantage in terms of accelerating the modal shift off a highway and onto rail?

Q

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

That's a great question, David, and clearly, what we've got in our service recovery plan with the STB is not our ultimate end game. And so the number that you're referencing for intermodal trip plan compliance isn't the aspirational end game. Ultimately, in the current environment, when that number is in the mid-80s to high 80s, low 90s, it's awesome. And where we are right now in the low- to mid-60s needs work, right? We need improvement.

A

Now, having said that, ultimately what every customer tells us, what they really care about, just do what you say you're going to do, I can adjust. And that's really what they want from us. So what we're trying to give them right now is markers that they can trust as we move through the back half of the year and use us and use our intermodal product to satisfy their needs, right? We're still – we can do huge volume at very competitive pricing compared to the alternative mode of truck. And we can do it reliably so long as we continue to improve our service product and promise something that we can actually deliver. Kenny?

Kenny Rocker

Executive Vice President-Marketing & Sales, Union Pacific Corp.

A

All I'll add is that we are always looking at our customers' success metrics. We talk about it often, we engage our customers, and that could continue to evolve.

David Vernon

Analyst, Sanford C. Bernstein & Co. LLC

Q

I mean, it strikes me as during some of these questions and service reviews with the STB and customers complaining about service, there's a big disparity around the definition of what rail service is. And, I mean, as you guys think about how you approach that business and how you contract with customers, is there something that you guys can do to better clarify kind of what that service level would be and maybe even use pricing to incentivize it? Because it does occur to me that there is a large customer in [ph] UPS (01:18:28) that does get good service, obviously they pay for it, but most other customers that are complaining about things like service, the ambiguity around what is service and that matching of price for service doesn't seem like it's maybe as tight as it could be. Is that something you guys are working on or thinking about at all?

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. We absolutely price for the product that we're providing to the customer base. We've got plenty of room to run there to continue doing that as you point out more effectively. And the other thing that you're pointing out is process, and we're working really hard right now on business process between ourselves and our customers to be crystal clear on what the service product is and what we can do and how much we can do, and then helping customers manage their business around that and managing our business around that as we continue to grow and improve our product. So, yeah, there's a lot of work around that, David, right now.

David Vernon

Analyst, Sanford C. Bernstein & Co. LLC

Q

All right. Thanks, guys. I'll follow up a couple more follow-ups later. Thanks.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Thank you.

Operator: Thank you. Our last question is from the line of Jairam Nathan with Daiwa. Please proceed with your question.

Jairam Nathan

Analyst, Daiwa Capital Markets America, Inc.

Q

Hi. Thanks for squeezing me in. I just wanted to follow up on a few questions that you have already answered regarding recessionary and plans there. So I think in the past you [indiscernible] (01:19:56) has been pretty nimble in cutting costs in the event of a volume decline, but do you foresee any changes to how you can adjust your labor given the difficulties that you've had this year to kind of – to get crew availability up. Do you see a different approach in the event of a recession or a volume downturn? Thanks.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yeah. Jairam, fundamentally the answer is no, we still – if there were a catastrophic downturn in the industrial economy, the goods economy, we would adjust very quickly to it. Now, having said that, on the margin, like we talked about very early in the call, we would be much more thoughtful about where and how much and how we would make those employees available to us when volume returned. So you'd probably see marginally some different behavior, but fundamentally we have the ability and has proven to adjust our business to whatever the environment is.

Jairam Nathan

Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Great. Thank you.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

A

Yes. Thank you, Jairam.

Operator: Thank you. This concludes the question-and-answer session. I'll now turn the call back over to Lance Fritz for closing comments.

Lance M. Fritz

Chairman, President & Chief Executive Officer, Union Pacific Corp.

Yeah. And thank you, again, Rob, and thank you all for joining us this morning. We appreciate it. We appreciate the Q&A with you. We look forward to talking with you again in October to discuss our third quarter results. Until then, take care.

Operator: Ladies and gentlemen, thank you for your participation. This does conclude today's teleconference. You may disconnect your lines at this time, and have a wonderful day.

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